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November 2, 2000

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BY COURIER

Magalie Roman Salas
Secretary
Federal Communications Commission
445 Twelfth Street, S.W. -- Room TWB-204
Washington, D.C. 20554

Re: CC Docket 00-176, Application by Verizon New England Inc., et al to Provide In-Region, InterLATA Services In Massachusetts

Dear Ms. Salas:

Pursuant to the Public Notice issued on September 22, 2000, please find enclosed an original and one copy of the Reply Comments of AT&T Corp. If there are any questions concerning AT&T's submission in this matter, please do not hesitate to contact me. Thank you for your attention to this matter.

Sincerely,

Michael J. Hunseder

Michael J. Hunseder

Enclosures

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FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF THE SECRETARY

Before the
Federal Communications Commission
Washington, D.C. 20554

In the Matter of	)	
	)	
Application by Verizon New England Inc.,	)	
Bell Atlantic Communications, Inc. (d/b/a	)	CC Docket No. 00-176
Verizon Long Distance), NYNEX Long	)	
Distance Company (d/b/a Verizon Enterprise	)	
Solutions), and Verizon Global Networks	)	
Inc. for Authorization to Provide In-Region	)	
InterLATA Services in Massachusetts	)	

REPLY COMMENTS OF AT&T CORP. IN OPPOSITION TO VERIZON NEW ENGLAND INC.'S SECTION 271 APPLICATION FOR MASSACHUSETTS

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Filed: November 2, 2000

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SHORT CITE	**FULL CITE**
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BA-New York Order	Memorandum Opinion and Order, *Application by Bell Atlantic New York for Authorization Under Section 271 of the Communications Act To Provide In-Region, InterLATA Service in the State of New York*, CC Dkt. No. 99-295, 15 FCC Rcd. 3953 (1999).
Local Competition Order	First Report and Order, *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, 11 FCC Rcd. 15499 (1996), *aff'd in part and vacated in part by Iowa Utils. Bd. v. FCC*, 120 F.3d 753 (8th Cir. 1997), *aff'd in part and rev'd in part by AT&T Corp. v. Iowa Utils. Bd.*, 119 S. Ct. 721 (1999).
SBC Texas Order	Memorandum Opinion and Order, *Application by SBC Communications Inc., et al Pursuant to Section 271 of the Telecommunications Act of 1996 to Provide In-Region, InterLATA Services in Texas*, CC Dkt. No. 00-65, 1999 WL 870853 (rel. June 30, 2000)
UNE Remand Order	Third Report and Order, *Implementation of the Local Competition Provisions of the Telecommunications Act of 1996*, CC Dkt. No. 96-98, 15 FCC Rcd. 3696 (1999).
Universal Service Order	Report and Order, *Federal-State Joint Board on Universal Service*, CC Dkt. No. 96-45, 12 FCC Rcd. 8776 (1997)

MISCELLANEOUS PLEADINGS CITED

DOJ Eval.	Evaluation of the United States Department of Justice, *Application by Verizon New England, Inc. et al for Authorization to Provide In-Region InterLATA Services in Massachusetts*, CC Dkt. No. 00-176 (October 27, 2000)

DTE	Comments of Massachusetts Department of Telecommunication and Energy, *Application by Verizon New England, Inc. et al for Authorization to Provide In-Region InterLATA Services in Massachusetts*, CC Dkt. No. 00-176 (October 16, 2000)
Hubbard Dir.	Direct Testimony of Robert Glenn Hubbard on behalf of AT&T Communications, Inc. , *AT&T/NYNEX Arbitration*, D.P.U. 96-80/81 (October 11, 1996)
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Phase 4 Decision	Order, *Petitions of New England Telephone and Telegraph Company d/b/a NYNEX, et al Pursuant to Section 252(b) of the Telecommunications Act of 1996, for arbitration of interconnection agreements,* D.P.U. 96-73/74 et al-Phase 4 (December 4, 1996)
Phase 4-A Decision	Order, *Petitions of New England Telephone and Telegraph Company d/b/a NYNEX, et al Pursuant to Section 252(b) of the Telecommunications Act of 1996, for arbitration of interconnection agreements,* D.P.U. 96-73/74 et al-Phase 4-A (February 5, 1997)
WorldCom	Comments of WorldCom, Inc., *Application by Verizon New England, Inc. et al for Authorization to Provide In-Region InterLATA Services in Massachusetts*, CC Dkt. No. 00-176 (October 16, 2000)

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Solutions), and Verizon Global Networks	)	
Inc. for Authorization to Provide In-Region	)	
InterLATA Services in Massachusetts	)	
	)	

REPLY COMMENTS OF AT&T CORP.

Pursuant to the Commission's Public Notice, AT&T Corp. respectfully submits these reply comments in opposition to Verizon's application for long distance authority in Massachusetts.

INTRODUCTION AND SUMMARY

The Commission's Order in this proceeding will be the seminal decision on the significance of the level of unbundled network element ("UNE") prices under 47 U.S.C. § 271 and under the Telecommunications Act of 1996 as a whole. In a real sense, the Commission is here at a crossroads. The path it chooses will determine whether there will be any prospect for UNE-based residential competition in most of the nation and whether there will be any broad-based competitive check on BOCs that receive long distance authority. That will determine AT&T's entry plans in the many states in the nation where AT&T has planned to rely exclusively or primarily on UNEs.

The fundamental reality is that Verizon has here sought long distance authority in a state in which there has been no, or virtually no, use of UNEs to provide residential service and in which CLECs have not even yet made the investments that would be required for them to provide UNE-Platform ("UNE-P") based residential services at a future time in Massachusetts. As explained in detail in WorldCom's opening comments and as the Justice Department provisionally accepts, the reason is Verizon's loop, switching, and transport rates that were set by the Massachusetts Department of Telecommunications and Energy ("DTE") in 1996. These rates are excessive under TELRIC or any measure of forward-looking costs. They manifestly do not provide sufficient margin for any firm profitably to provide broad-based local service in Massachusetts using UNE-P. In an 11th hour attempt to "eliminate" this issue, on October 13, Verizon filed an amended tariff that maintains its excessive loop rates, but that adopts (without any supporting documentation) switching and transport rates that are purportedly equivalent to the rates Verizon now charges in New York. Even if these rates provided sufficient margins for local entry in Massachusetts – as they palpably do not – Verizon's prior rates foreclosed CLECs from implementing arrangements that would allow them to offer UNE-based residential services now. The Massachusetts market is thus irrefutably not "irreversibly open" today.

Although Verizon has engaged in extraordinary machinations to obscure the issue, the DTE has forthrightly and starkly posed the critical question that the Commission must decide. The DTE has candidly urged the Commission to approve the application by holding that its 1996 loop, switching, and transport rates satisfy TELRIC – even though these rates concededly rest on inputs that are between 20 and several hundred percent higher than those used in other Verizon states (and even higher still than inputs used in the Commission's USF TELRIC determinations). The DTE can point to no facts unique to Massachusetts that can justify the differences, and some of the DTE's chosen inputs rest on grounds that are flatly contrary to the Act and to the Supreme Court's decision in *AT&T* v. *Iowa Utilities Board.* But the DTE claims that because the Commission has held that rates *can* differ in different states, any differences are permissible so long as the state purports to apply TELRIC.

The DTE similarly does not deny that the rates provide insufficient margins to allow UNE-based competition, and Verizon too has failed to make any contrary showing. But the DTE candidly urges the Commission to hold that this fact is irrelevant. DTE at 338-40. In its view, the fact that UNE rates are too high to allow profitable entry is neither probative of whether the rates violate the checklist nor a factor having any significance to the separate public interest determination that the Commission must make. In the DTE's view, it does not matter what the UNE rate levels are; it does not matter whether widespread alternatives to the BOC's residential services can in fact develop; and it does not matter that BOCs will continue to have intractable monopolies in the vast regions of the country where UNEs are today the only viable means of providing competing exchange and exchange access services.

In the recent past, AT&T had no direct interest in UNE-P rates to serve residential customers in Massachusetts,[1] for AT&T acquired a substantial cable television presence in this state and hopes to use its cable facilities to offer service to residences passed by those cable systems in Massachusetts. But AT&T's cable systems do not pass all Massachusetts residences and, more importantly, the Commission's decision on Massachusetts will profoundly affect AT&T's entry plans in many other states in the nation in which AT&T plans to enter solely or largely through UNEs.

[1] This could change as AT&T's recently announced restructuring, which expressly contemplates inter-unit competition, is implemented.

Foremost, if the Commission were to grant this application (either now or after the cosmetic step of restarting the clock as of October 13), the Commission would be making it explicit to the world that its TELRIC pricing standard is meaningless and that the Commission has ceded to state utility commissions the authority to adopt prices that preclude UNE-based local competition and to allow the BOCs to retain their local monopolies and remonopolize long distance services. That decision would be the final repudiation of the Commission's *Local Competition* and *Ameritech Michigan* orders, and would relinquish the jurisdiction that Congress gave the Commission to advance compelling national interests, which the Supreme Court expressly upheld in *AT&T* v. *Iowa Utilities Board.* Such a decision would effectively put an end to the efforts of AT&T and others to pursue UNE-based entry in the many states with similarly excessive UNE rates, for those prospects had there been kept alive only by the possibility that the Commission would enforce and further define its pricing rules, and deny § 271 authority to BOCs whose UNE rates do not satisfy TELRIC and do not allow competition to develop.

Conversely, if the Commission were to deny this application, it would establish at a minimum that the Commission is willing to reject excessive state-approved prices that merely purport to apply TELRIC, and that the Commission is not indifferent to whether rates have been set at levels that realistically allow UNE-based competition to develop. And if the Commission were to take the additional steps of reaffirming the commitments it made in the *Local Competition* and *Ameritech Michigan* orders and reiterating that TELRIC requires the same rates in all locales having the same characteristics, the result would be a renewed and broadened commitment by CLECs to pursuing the entry through UNEs that alone can today provide ubiquitous alternatives to the LECs' exchange and exchange access services. The reality is that the economics of UNE-based entry depend just as critically on the existence of rates that precisely reflect the economic costs that the incumbent LEC in fact incurs when it uses the facilities as it does on the availability of adequate OSS. Because even seemingly small deviations of rates from TELRIC can cripple the use of UNEs as competitive entry vehicles, the strict enforcement of TELRIC by a committed expert body is essential if this entry is to occur and to be effective.

The remainder of these comments is divided into three parts. Part I replies to the DTE's attempts to defend the loop, switching, and transport rates that it adopted in 1996 and that remained in effect until Verizon proposed (and the DTE immediately accepted) new transport and switching rates on October 13. It demonstrates that the DTE's claims rest on the false premise that so long as states do not expressly use embedded costs, TELRIC allows states to depart from the FCC's and other state determinations based not on facts unique to the state, but on the state commission's own policy preferences. In showing that loop, switching, and transport rates are excessive, AT&T will demonstrate in detail that although Verizon testified that it has the same cost of capital in all its states, the DTE adopted a rate of return that is a full 20 percent higher by assuming (contrary to the Act) that Verizon faces competition in providing UNEs and by making other wholly unwarranted and counterfactual assumptions. Finally, this section demonstrates that the fact that UNE rates are too high to allow competitive entry is conclusive, or virtually conclusive, proof that the rates do not satisfy TELRIC. In all events, if UNE-based competition is infeasible, a grant of long distance authority cannot be in the public interest.

Part II demonstrates that the October 13 rate filing affords no basis to grant the application (either now or after the cosmetic and pointless step of "restarting the clock"). That is so for two reasons. First, these rates are patently insufficient to establish implementation of the

Act's pricing requirements. Even if the loop, switching, and transport rates were the same as New York's, the New York rates were approved in part on the basis that factors unique to New York meant that costs were higher there than in other Verizon states, and Verizon's New York rates are substantially higher than those set in other Verizon states that are, if anything, costlier to serve than Massachusetts (*e.g.*, Vermont and Pennsylvania). Further, the October 13 filing did not change the loop rates, so Verizon is continuing to charge the grossly excessive loop rates that the DTE approved. Beyond that, the conditions that led the Commission to grant the New York application are not present here. In sharp contrast to conditions in Massachusetts, the Commission granted the New York application because: (1) UNE-based entry was already occurring in New York on a substantial scale; and (2) although there was evidence that the New York UNE-P rates were excessive, the NYPSC had demonstrated an understanding of and commitment to TELRIC and had committed to reconsider the UNE rates and order retroactive refunds. Finally, Verizon's and the DTE's reliance on existing UNE rates in New York is supremely ironic, for Verizon's CEO has proudly stated that because of the level of these UNE rates, AT&T cannot today be "making any money on it[s]" UNE-P-based service.

Second, § 271 would prohibit the grant of long distance authority even if the October 13 rates complied with TELRIC and even if they had been adopted shortly before the application was filed (rather than 21 days thereafter). Because Verizon's earlier rates had squarely foreclosed any firm from even considering making broad-based use of UNEs, Verizon assured that no CLEC would go through the laborious and expensive effort of establishing the systems required to provide service through UNEs, that there would be no commercially meaningful experience with its OSS and other UNE systems, and that there could be no meaningful UNE-based competition in Massachusetts for a minimum of several months. To grant the application would thus make Verizon the only firm able to offer broad-based packages of local and long distance service now and in the near future. That is why § 271 mandates a process in which a BOC first establishes interconnection agreements or arrangements that facially comply with the Act's requirements and in which there are then sufficient opportunities for commercial implementation to establish that the market is irreversibly open. That has not occurred here, and the public interest would require that the application be denied even if the October 13 rates could later be found sufficient. For this reason, AT&T opposes any suggestion that "restarting the clock" is an adequate response to Verizon's tactics. If the application were then granted, Verizon's ploy would have succeeded in foreclosing competition in Massachusetts for the foreseeable future. Nor would this measure deter Verizon and other RBOCs from employing similar tactics in the future.

Finally, Part III explains in detail that effective UNE competition simply will not develop unless the Commission rejects the instant application and adheres stringently to the commitments it made in the *Local Competition* and *Ameritech Michigan* orders. In this regard, the Commission need not await the filing of § 271 applications to begin taking an active role in assuring that UNE prices in fact satisfy TELRIC. As it committed to do in 1996, the Commission can readily – and should – use its rulemaking and declaratory ruling authority to specify the requirements of TELRIC in further detail and to prescribe how it should and should not apply in particular circumstances. If the Commission does so, federal district court review of state decisions can achieve its intended function, and it will be an easy matter for BOCs to develop rates that satisfy the Act and for the Commission to conduct the required review of UNE rates during the statutory 90-day period in future § 271 proceedings. By contrast, if the Commission fails vigorously to enforce TELRIC in § 271 and other proceedings, BOCs will ruthlessly capitalize on the perceived failure of the Commission to adhere to these commitments – as Verizon plainly attempted to do here. Unless the Commission now acts decisively, it will simply be assuring the failure of the 1996 Act.

I. VERIZON'S 1996 LOOP, SWITCHING, TRANSPORT, AND OTHER UNE RATES VIOLATE TELRIC.

The application should be assessed based on the sufficiency of the loop, switching and transport UNE rates that the DTE approved in 1996 and that remained in effect until October 13 of this year. These are the rates on which CLECs relied in determining not to invest in the operations support systems and related development work required to implement UNE-P-based residential service in Massachusetts. It is because of these rates that there has been no UNE-P entry in the past, and there would be no immediate prospect of broad-based UNE-P service in Massachusetts even if Verizon had adopted TELRIC-compliant rates the day before its application was filed.

Accordingly, in contending that Verizon has satisfied the UNE pricing requirements of the checklist, the DTE's Comments have offered a lengthy defense of its 1996 pricing decision. The DTE contends that its loop, switching, and transport rates satisfy TELRIC both as a matter of law and as a matter of fact, and that it is irrelevant that the rates do not permit UNE based entry (DTE at 315-44). But there is no substance to DTE's claims. The rate issues raised here are not even remotely close questions. As WorldCom and others have demonstrated, the Verizon rate methodology that the DTE endorsed is patently erroneous in its particulars and includes an inflated cost-of-capital assumption that grossly inflates all of Verizon's UNE rates. These errors are not mere "details" or "isolated factual findings." DTE at 310. Rather, the DTE set rates that artificially, clearly, and significantly inflated the costs of UNEs in Massachusetts, and its explanations for its decisions confirm that it did so because the DTE has policy views that are antithetical to TELRIC and to the Act's objectives.

The DTE's October 16 Comments confirm these fundamental errors, and dramatically underscore why the promotion of the policies of the 1996 Act mandates that the Commission vigorously enforce TELRIC in § 271 and other proceedings. In particular, the DTE's comments make three basic points, each of which is erroneous. First, the DTE wrongly suggests that Verizon is not here required to demonstrate that its rates comply with TELRIC, and that review of the DTE's individual rate determinations is itself antithetical to TELRIC. Second, the DTE attempts to defend its cost-of-capital determination, its switching and transport rates, and its other UNE rates as a whole. But this defense serves only to illustrate how far it departed from basic TELRIC principles. Finally, the DTE wrongly – but tellingly – argues that it is "irrelevant" both to TELRIC and to the evaluation of Verizon's application under the public interest test that its 1996 rates foreclosed the use of UNEs for actual entry.

A. Contrary To The DTE's Suggestion, TELRIC Applies And Mandates That Individual UNE Rates Be Based On Forward-Looking Costs In The State.

The DTE states that it "set VZ-MA's UNE rates according to the FCC's TELRIC methodology" (DTE at 316), but the DTE appears to suggest that the Eighth Circuit's decision[2] might allow the Commission to approve the application without finding that Verizon's rates satisfy TELRIC. DTE at 308-09. Any such suggestion is baseless. The DTE has overlooked the fact that, pending Supreme Court review, the Eighth Circuit stayed its mandate insofar as it vacated a portion of the Commission's TELRIC rules. Beyond that, the DTE's 1996 rates rest on grounds that would violate the Commission's regulations even as they would have been modified if the Eighth Circuit's mandate had not been stayed, for the Eighth Circuit upheld TELRIC's

[2] *Iowa Utilities Board* v. *FCC*, 219 F.3d 744 (8th Cir. 2000), petitions for certiorari pending.

requirement that rates be forward-looking and vacated only the subsection of the rule that required that rates be based on the most efficient facilities and network design. Here, the DTE's error is that it departed from forward-looking principles.

The DTE makes a series of arguments to the effect that the rates that it established must be deemed to satisfy TELRIC as a matter of law. The DTE's position is that the claims that the DTE used "inputs" that are wildly excessive are not cognizable in this (or any other) assessment of the sufficiency of Verizon's rates. Several of these claims relate to the specific challenges to the DTE's cost-of-capital and switching rate determinations, and will be discussed below. But two apply to all of the issues.

First, the DTE claims that because the Commission's rules give states "flexibility" to set UNE rates based on "local conditions," the DTE's choices of particular local "inputs" raises no issues for this Commission to review. DTE at 336 & n.659. The DTE's view, apparently, is that so long as a state does not explicitly use an historical cost method and claims to determine forward-looking replacement costs, the state is free to adopt whatever inputs it chooses. The DTE thus apparently believes it has no burden of defending its choices and may depart, at will, from the determinations that the Commission or other states have made in assessing the costs of the same inputs in economically indistinguishable conditions.

This extreme claim is necessary to defend the DTE's 1996 rates. For example (as explained more fully below), Verizon's own witnesses testified that it has essentially the same cost of capital in all of its states. But the DTE set Verizon's cost of capital 200 basis points higher than did other states in Verizon's region, and did so without identifying any factual differences between Massachusetts and other states that could explain this or any other difference. The DTE's cost-of-capital determination rests instead on methodological assumptions that are irreconcilable with forward-looking cost principles, and on a policy view that state commissions should be immune from substantive review by this Commission in the § 271 process.

The DTE's claim of immunity from this Commission's review is simply wrong. It is true, as the DTE notes, that forward-looking costs can vary from state to state, and state rate determinations are to be based on the terrain, and demographic, technological, and other conditions that apply in that state. *Local Competition*, 11 FCC Rcd. at 15812; *Ameritech Michigan*, ¶¶ 291-92. But rates should differ significantly from one state to another only where there *are* different economic conditions that would cause forward-looking costs to be higher in one of the states. A state cannot achieve divergent results simply because it has its own distinctive policy preferences that are inconsistent with those of Congress and the Commission. Yet that is what the DTE has done.[3]

Second, the DTE argues (at 336-37) that its individual loop, switching, and transport rates should be immune from "network-element-by-element analysis." In the DTE's view, the Commission should "take into account all of the [DTE]'s UNE rate decisions" in considering challenges to the "small subset of the total" challenged here. This claim is without merit. First, the Act requires that *all* UNEs in the checklist be provided consistent with the requirements of Sections 251 and 252. In addition, cost of capital errors infect all of Verizon's UNE rates, and

[3] The DTE is also wrong in dismissing the cost determinations that the Commission made under its USF proceedings. These determinations rest on rigorous applications of the same TELRIC standard that applies to the pricing of UNEs under § 252(d)(1) of the Act, and the Commission made TELRIC determinations for each locale in Massachusetts (and the nation as a whole). Although the Commission used nationally averaged values for a number of inputs, there is no basis for a state to reach different results unless there is evidence that the costs in the state for the particular inputs differ from the national averages on which the Commission relied. Neither Verizon nor the DTE has identified any such evidence relevant to the rate disputes here.

thus there are not, even in theory, any "good" rates against which the Commission could balance the clearly unlawful rates. Even if that were not the case, however, the DTE does not contend that any rates are below cost, much less so far below cost that they could make up for the massive inflation caused by the DTE's errors in its determinations on cost of capital and switching, transport and loop costs. And, if the DTE means to suggest that the bottom-line impact of the identified errors is insignificant, that would also be incorrect. As MCI has demonstrated, the price of the UNE platform in Massachusetts exceeds Verizon's forward-looking cost of providing the platform by enough to foreclose UNE-based service to most Massachusetts residents.

Indeed, the DTE is incongruously arguing both (1) that the Commission can only consider the overall impact of rates and (2) that it is "irrelevant" that the "overall impact" is to provide insufficient margins to allow UNE-P competition. But DTE is wrong on both counts. Checklist item two requires that each UNE price comply with the cost-based pricing requirements of the Act. And the evidence of overall impact is (as explained below) virtually conclusive of the unlawfulness of the rates. In short, the DTE's efforts to evade substantive review of its network element rates should be rejected.

B. The DTE's Cost Of Capital And Other Rate Determinations Are Erroneous.

The DTE's attempts to defend its specific ratemaking determinations all fail. That is manifestly the case in each of the three most important areas where the DTE uncritically accepted Verizon's inflated cost assumptions: (1) cost of capital; (2) switching and transport costs; and (3) loop costs. DTE's comments make it explicit that these rates are based not on forward-looking costs, which, at least for key items like cost of capital and switching, should be no higher in Massachusetts than in other Verizon states.

1. Cost of Capital. The cost of capital measures the forward-looking capital costs of supplying unbundled network elements at wholesale. As the DTE recognizes, the cost of capital is "an input to all UNE prices." DTE at 330. It thus affects the rates for *every* network element offered in Massachusetts, including those rates – such as for loops – that were unaltered by Verizon's October 13 rate reductions. Proof that the cost of capital has been set at a level that substantially exceeds the level produced by application of forward-looking cost principles therefore precludes any finding that Verizon's UNE-rates are cost-based.

The DTE unquestionably set the cost-of-capital at a level far beyond what any rational application of forward-looking principles would produce. The DTE adopted a weighted average cost of capital of 12.16 percent—by far the highest value adopted by any state commission in Verizon's service area. *See* Cornell/Hirshleifer Decl. ¶¶ 44-45. Indeed, the average cost of capital established by other state commissions in the Verizon region was approximately 200 basis points lower than the DTE's level. *See* Cornell/Hirschleifer Decl. ¶¶ 15-16.

The inflated cost of capital approved by the DTE cannot be rationalized as the product of unique local conditions in Massachusetts. Verizon proposed virtually the same cost of capital, based on the same methodology and virtually the same data, in Massachusetts as elsewhere in the region. Other state commissions on the Eastern seaboard rejected Verizon's approach not because those states have different cost characteristics than Massachusetts. They did so because they unanimously agreed that Verizon's methodology suffered from the extremely basic conceptual errors identified by WorldCom and AT&T.[4]

The DTE mischaracterizes the challenges to the cost-of-capital as complaints that "VZ-MA's *actual* cost of capital is lower than the costs assumed by the Department"; it then argues that the Verizon's actual cost of capital is "not relevant to a determination of whether a state commission has reasonably applied TELRIC principles" because "TELRIC is not designed to match historic or actual costs of the ILEC." DTE at 330-32. This argument attacks a strawman. No party has proposed limiting the forward-looking cost of capital to the embedded cost of Verizon's outstanding debt; and estimating the cost of equity is, by definition, always a forward-looking exercise focused on *expected* risks and cash flows.[5] The issue here is whether the forward-looking risks and cash flows assumed by the DTE were the relevant ones. They were not.

As the DTE correctly notes, calculating the cost-of-capital requires determining the cost of equity, the cost of debt, and the relative percentage of equity and debt in a forward-looking

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[4] Cornell/Hirshleifer Decl. at ¶ 15 n. 8 (citing cases). Indeed, the DTE set the cost-of-capital at a level far in excess of the forward-looking estimate that Verizon's corporate predecessors filed with shareholders and the SEC in connection with the Bell Atlantic-NYNEX merger. At the same time that Verizon's predecessors were presenting a 12.16% cost-of-capital to the state commissions in its region, they presented a proxy statement to shareholders and to the SEC that estimated an overall, forward-looking cost of capital in the range of only *8-10 percent* based on analyses by Bell Atlantic's investment advisor, Merrill Lynch. *See* Cornell/Hirshleifer Decl. ¶¶ 18-20, 22-24. Federal securities laws require statements of fact, as well as opinions and projections, in filings of this kind to be truthful and accurate. *See Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 381-82 (1970); *Gould v. American Hawaiian Steamship Co.*, 535 F.2d 761, 777 (3d Cir. 1976); *Herskowitz v. Nutri/System, Inc.*, 857 F.2d 179, 184 (3d Cir. 1988).

[5] Cornell/Hirshleifer Decl. ¶ 43 & n. 40. Alfred Kahn, a frequent consultant for Verizon and other RBOCs in recent years, has noted that "what investors are capitalizing in the purchase price of the securities they buy is not current but anticipated earnings." 1 Alfred E. Kahn, *The Economics of Regulation* 46-47 (1970).

capital structure. DTE at 323-24. But the DTE failed to correct for three fundamental errors in Verizon's Discounted Cash Flow ("DCF") analysis – the most significant of which the DTE expressly recognized. Specifically, Verizon: (1) assumed, in calculating the cost of equity, that the above-average short run growth rates of companies in the DCF comparison group will continue forever; (2) based its discounted cash flow analysis of the cost of equity on a group of 400 industrial companies that face significantly higher risks than Verizon; and (3) assumed a capital structure with far more equity (and far less debt) than would be efficient for a business with the relatively low risks of supplying UNEs at wholesale.[6] These three errors alone inflated the cost of capital proposed by Verizon from the true forward-looking value of about 10 percent to 13.18 percent.

First, a DCF model estimates a firm's cost of equity capital on the basis of the stock prices and expected future earnings of publicly traded companies that face comparable risks. Verizon's single-stage DCF analysis used a group of companies that are projected to earn supra-normal rates of earnings growth in the next few years, but assumed that this above-average rate of earnings growth would continue *forever*. *See* Cornell/Hirshleifer Decl. ¶¶ 38-39, 48-54. As a longer run projection, this assumption is nonsensical: if any one company indefinitely grew faster than the market overall, it would eventually grow to the size of the entire economy. *See* Hubbard Reb. (Oct. 30, 1996) at 7-8; Cornell/Hirshleifer Decl. ¶¶ 49, 53.

The DTE recognized the clear error in Verizon's perpetually high growth assumption and initially directed Verizon to resubmit its cost study with a proper multi-stage growth assumption. See Phase 4 Decision 51-52 (directing Verizon to resubmit its study "in accordance with the three stage growth methodology used by [AT&T witness] Dr. Hubbard" which the DTE found

[6] DTE Phase 4 Decision (Dec. 4, 1996) at 37-53.

"uncontroverted and reasonable"). The DTE got cold feet, however, when Verizon objected that correcting this error would reduce the cost of capital from Verizon's original proposal of 13.16 percent to 10.5 percent (by reducing the cost of equity from Verizon's 14.8 percent proposal to the 11.38 percent value that resulted from a three-stage growth assumption). Rather than insist on the full correction, the DTE pronounced a 13.5 percent cost of equity reasonable without any explanation of how it derived that figure. *See* Cornell/Hirshleifer Decl. ¶¶ 40-41; DTE at 323 (citing Phase 4 Decision at 6).

The DTE has never advanced a valid explanation for this outcome, which on its face is internally inconsistent. Without a one-stage DCF assumption, it is mathematically impossible to derive a cost of equity in the range of 13.5 percent (or an overall cost of capital in the range of 12.16 percent) from the remaining assumptions of Verizon's cost of capital study, *even if one accepts Verizon's claim that its local business is as risky as the average S&P 400 industrial company.* *See* Cornell/Hirshleifer Decl. ¶¶ 39, 46-47. Moreover, the DTE's assertion that applying a three-stage DCF analysis to S&P 400 comparison group selected by Verizon would generate a cost of capital lower than justified by DTE's "qualitative" assessment of risk is entirely baseless. For any given group of companies in a DCF comparison group, the degree of risk assumed in a one- and three-stage DCF is *identical.* *See* Cornell/Hirshleifer Decl. ¶ 46. Both the 14.18 percent equity cost derived by Verizon with a one-stage model and the 11.38 equity cost derived with a three-stage model use the same S&P 400 comparison group, and thus arise from the same implicit assessment of risk. The *only* difference between the two DCF models is that the three-stage DCF properly recognizes the inability of a company to grow faster in perpetuity than the overall economy.

Second, Verizon ignored forward-looking costing principles in choosing the DCF comparison group. A valid DCF analysis requires that the comparison firms have the same overall risk as the business being assessed, for the perceived risk of the business is a primary determinant of its cost of capital.[7] Verizon's comparison group, however, was not limited to publicly traded telephone companies (let alone to wholesale suppliers of UNEs), but included the diverse collection of 400 industrial firms in the S&P Industrials list. *See* DTE at 321-22. The DTE now defends this comparison group on the theory that network elements are a "hybrid set of assets, having some of the characteristics of monopoly bottleneck facilities while also displaying some characteristics of speculative, unsecured investments," generating a "level of business risk" that is "higher than that which would apply to a monopoly bottleneck facility." DTE at 321-33 (citing Phase 4 decision at 44-46).

The DTE's defense has no merit. The only meaningful competitive risks that Verizon faces are at the retail level; for the line of business whose capital costs are relevant here – *i.e.*, the wholesale provision of UNEs – Verizon faces no significant competition at all.[8] Moreover, the extraordinary cost of duplicating Verizon's facilities will shield Verizon from any significant competition for the foreseeable future.[9] And while CLEC entry may increase

[7] *See Local Competition Order* ¶ 700; *FPC* v. *Hope Natural Gas Co.*, 320 U.S. 591, 603 (1944) ("[T]he return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks").

[8] *Local Competition Order* ¶ 691; *Bell Atlantic-Delaware, Inc. v. McMahon*, 80 F.Supp.2d at 240-41; *see also Southwestern Bell, infra*, slip op. at 25 ("until facilities-based competition occurs, the impact of competition . . . will be minimal").

[9] "Congress recognized that the amount of time and capital investment involved in the construction of a complete local stand-beside telecommunications network are substantial barriers to entry, and thus required incumbent LECs to allow competing carriers to use their networks in order to hasten the influence of competitive forces in the local telephone business." *Iowa Utilities Bd. v. FCC*, 120 F.3d 753, 816 (8th Cir. 1997), *cert. granted* on other grounds, 522 U.S. 1089 (1998); *accord, Local Competition Order* ¶ 10, 231.

competition at the retail level, that will only increase demand for Verizon's network elements.[10] In this regard, DTE's assumption that UNEs are provided in competitive markets is squarely inconsistent with the Act and prior Commission findings. Under these authorities, incumbent LEC loops, switches, and transport facilities are UNEs only because there are no competitive alternatives to LECs in vast parts of the country. *UNE Remand Order*, ¶¶ 44-45, 181-200, 253-275, 321-379; *see AT&T v. Iowa Utilities Board*, 525 U.S. at 387-392.

It is therefore unassailably true that the S&P 400 face risks from competition far greater than those confronting a wholesale supplier of UNEs. For that reason, this Commission and state commissions have repeatedly held that DCF analyses based on such industrial companies cannot provide a valid estimate of the cost of capital of a telephone carrier.[11]

Third, the DTE improperly assumed a capital structure with a high ratio of equity (76%) to debt (24%). Efficient firms reduce their overall capital costs by using debt rather than equity capital to the maximum prudent extent. Thus, unless a more leveraged capital structure would create too much financial risk, a capital structure consisting primarily of equity is needlessly costly and inefficient. *See* Cornell/Hirshleifer Decl. ¶¶ 33-34, 66-69.

The DTE defends the use of a deeply unleveraged debt-equity ratio as "market-based." But it relies on the ground not that other local phone companies have the assumed debt-equity ratio (for they do not), but on the fact that S&P 400 firms generally do. DTE at 323. Here, however, the firm modeled is a wholesale provider of UNEs, which faces much less risk, and

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[10] *See* Cornell/Hirshleifer Decl. ¶¶ 56-57; *Bell Atlantic-Delaware*, 80 F.Supp.2d at 241.

[11] See, e.g., *Represcribing the Authorized Rate of Return for Interstate Services of Local Exchange Carriers*, 5 FCC Rcd. 7505 (1990), ¶ 162; *Bell Atlantic-Delaware, Inc. v. McMahon*, 80 F.Supp.2d 218, 240-41 (D. Del. 2000).

which thus would efficiently adopt a more leveraged capital structure. *See* Cornell/Hirshleifer Decl. ¶¶ 66-69.

2. Switching and Transport Costs. In its October 16 comments, WorldCom identified numerous errors in the DTE's estimate of switch investment costs, including the DTE's: (1) decision to base switching investment on prices reflecting *only* the shallow discounts available for add-on purchases, and disregard entirely the substantially deeper discounts available for new equipment purchases; (2) adoption of an inflated cost factor for switch installation; (3) erroneous annualization of busy hour minutes of use; (4) adoption of an unduly low port utilization factor; and (5) approval of an excessive building cost factor. Correcting these errors would reduce the switch costs by as much as 75 percent. *See* WorldCom at 5-28; Bryant Decl. ¶¶ 12-33. The DTE made similar errors with respect to transport costs. *See* WorldCom at 28-30.

The DTE's comments addresses only the issue of switch discounts. On that issue, the record refutes the DTE's claim that exclusive use of the shallower add-on discounts was "appropriate and supported by the record." DTE at 320 (quoting DTE Phase 4A Order) at 9-10. Indeed, even if it could be consistent with forward-looking principles to apply the shallower add-on discount to some *fraction* of switch purchases, there is no possible justification for the DTE's assumption that an efficient entrant would purchase *all* switching equipment at the shallow discount.

The DTE notes that, because Verizon's existing switches in Massachusetts are digital switches of recent vintage, the additional purchases it makes in the next few years are likely to be limited to add-on capacity to handle projected growth. From this unobjectionable premise, the DTE leaps to the absurd conclusion that, because the *short run* incremental unit costs of

Verizon's add-on switch purchases in the next few years are likely to be high, the Commission should pretend that the *long run* incremental costs of its *baseload* switching capacity are equally high. *See* DTE 320. But no rational carrier, real or hypothetical, long run or short run, would pay so much for its baseload switching capacity. A rational carrier to the maximum extent possible would take advantage of the deep discounts available for "new" equipment purchases—as Verizon itself has done. The notion that an efficient firm would buy all of its baseload capacity at the higher unit prices of add-on capacity is at odds with the most basic forward-looking costing principles, as well as the behavior of any rational firm in the industry. Indeed, Verizon's own principal witness on economic costing principles has conceded as much.[12]

In these circumstances, the DTE's insistence that it is "speculative to assume what the manufacturers' discounts would be if a TELRIC network were being constructed today" is nothing less than a repudiation of TELRIC. *See* DTE at 320 (quoting Phase 4 Order (Dec. 4, 1996) at 47). There is, moreover, nothing speculative about the deep discounts offered by switch vendors such as Lucent, Nortel and Siemens to local carriers like Verizon for purchases of new switching equipment: the availability of those discounts to Verizon is a matter of record.[13]

Actual experience also refutes the notion that switch vendors would eliminate their discounts for new equipment purchases if Verizon and its peer companies sought to acquire most of their switching equipment at new equipment discounts. The current price discounts arise from

[12] The witness, Dr. William Taylor, conceded in the 1996-97 UNE proceedings in New Jersey and elsewhere that Verizon's approach of treating *all* switching investment as "add-on" was inconsistent with forward-looking pricing principles. The *Local Competition Order*, he admitted, "says rip every switch out. All of them. . . . Every switch in the network, rip them out. . . . And build the network that you would build today to serve the demand." *See Bell Atlantic-Delaware* v. *McMahon*, 80 F.Supp.2d at 238-39 (quoting Dr. Taylor's statements).

[13] *See Bell Atlantic-Delaware v. McMahon*, 80 F.Supp.2d at 237.